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C O N F I D E N T I A L SECTION 01 OF 02 BUDAPEST 000760

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SUBJECT: LOCAL GOVERNMENT SEIZURE OF WATER UTILITY FURTHER
THREATENS INVESTMENT CLIMATE

REF: 08 BUDAPEST 954

Classified By: Economic Officer Jeffrey Jordan, reasons 1.4 (b),(d)

11. (C) Summary: The Pecs city government has used a commercial dispute with France's Suez, the strategic investor and operator of the city's water plant, to basically expropriate the public utility. The move was orchestrated by the newly-elected Fidesz mayor and has raised serious concerns in both the government and business community, with a clear negative impact on Hungary's investment climate. End summary.

FRENCH INVESTORS FACE LOCK-OUT FROM PECS WATERWORKS

12. (SBU) On Monday, October 5, the Pecs local government sent security guards to occupy the headquarters of the city's waterworks, Pecszi Vizmuvek. The move prevented the management of French investor group Suez, which holds a 48.5 percent stake in the company and exercises management control, from entering the building. According to local media accounts, the city of Pecs, owner of a 50.5 percent stake in the waterworks, informed Suez on September 10 that it wished to terminate its service contract, and did so on September 30, after the two parties failed to resolve a dispute concerning Suez's management of the company. The city has also announced its intention to buy back the French company's stake. Although the conflict between the two owners has reportedly been brewing for the past five years, Pecs's move to expropriate Pecszi Vizmuvek stems from an investigation into the company initiated by the city's new Fidesz mayor Zsolt Pava, who was elected to his post in May 12009. (Note: According to local press, Mayor Pava oversaw the initial sale of Pecszi Vizmuvek to Suez' predecessor company in 1995 while serving a previous term as Pecs mayor. End note.)

13. (SBU) Ivan Szabo, the lawyer representing Pecs in the matter, told an Embassy Econ Section member that Suez had breached the privatization contract by drawing a management fee of two percent of total revenue and by funding investments into seventeen small local water companies with bank loans obtained by Pecszi Vizmuvek. Roughly half of these investments allegedly occurred without approval by the municipality as majority shareholder. According to Szabo, Pecs was compelled to take over operations of Pecszi Vizmu after Suez refused to negotiate in order to ensure uninterrupted water supply to the local population. (Comment: Szabo was unable to provide a convincing explanation as to why the city's water supply would have been at risk. End comment.) Szabo, however, disputes media characterizations of a "raid" on the waterworks. He called

it a "normal handing over of the company."

CRISIS-MANAGEMENT GOVERNMENT SERIOUSLY CONCERNED

14. (C) Viktor Szigetvari, Chief of Cabinet to Prime Minister Bajnai, told the Charge d'Affaires on October 14 that the Prime Minister plans to issue a statement condemning the Pecs government's actions, which have sent a negative message to foreign investors. According to Szigetvari, the city's actions reflect Fidesz and extreme-right Jobbik's hostility to foreign investment. Although the Pecs government may have been within its rights, given its majority on Pecs Vizmuvek's board, Szigetvari commented that forcibly taking over the company headquarters was not the appropriate way to handle the issue. (Note: According to local press, Socialist members of the Pecs city council also agree with the buyback of the company, but not with the methods employed. End note.)

EVEN DARKER MOTIVES?

15. (C) Laurent Niddam (strictly protect), an Amcit legal expert affiliated with the American Chamber of Commerce in Hungary with extensive experience in investment arbitration, told Econoff that the Suez affair could also be a sign of high-level corruption. According to Niddam, Hungary's restrictive, though widely ignored, campaign finance rules (reftel) effectively encourage Hungary's political parties to search for illicit revenues.

16. (C) In Niddam's experience, public procurement contracts

BUDAPEST 00000760 002 OF 002

and regulated public utilities are the most commonly used "cash machines" for illicit party financing, and Pecs Vizmuvek is an attractive target because it has both elements, as water companies generally must re-invest about 25 percent of their annual revenue to maintain their pipe networks. Moreover, he says that the current case is a page directly from an old Fidesz playbook, noting that an almost identical dispute arose in 1999 between the city of Szeged's Fidesz mayor and France's Vivendi.

17. (C) In response to Szabo's allegations about Suez' management practices, Niddam said that management fees were a common feature of privatization contracts undertaken in the early-mid 1990s and argued that it would not be possible for such fees to be paid or large debts and investments to be undertaken without approval by the company's board of directors, which includes representatives from the municipality. As such, he considers the city's claims a spurious pretext for taking over the company.

18. (C) Marie-Cecile Tardieu-Smith, Commercial Counselor at the French Embassy, voiced similar concerns to Econoff and added her view that the asset seizure was being orchestrated from above, either by regional or national level leadership. She noted that Mayor Pava had previously taken a very friendly stance toward foreign investors and had always maintained good contact with the French Embassy, but that their communications had all but ceased since the trouble with Suez began. She added that she had heard from her contacts that Pava "had been pushed" to take over the company. She did not exclude the possibility that the French firm may have made some mistakes in its handling of the affair but emphasized that there was no mention of contractual difficulties in mid-September when the French learned of the city's desire to buy back the company. The French Embassy is very concerned that other French investors may also become targets, a point she says that France's EU Affairs Minister recently raised with the GoH while in Budapest.

FOREIGN INVESTORS LIKELY TO PAY (OR STAY AWAY)

19. (C) Comment: Corruption and widespread ambivalence about

the role of foreign companies in the economy have made Hungary's investment climate a challenging one since the beginning of post-Communist transition, regardless of who has been in power. The coming elections are likely to push all parties toward questionable activities in their search for campaign funds. End comment.
LEVINE